KEYNOTE INTERVIEW

Sharpening impact's blurred edges

Greater clarity, precision and standardisation can help the impact investing market reach its full potential, say Jeremy Elmore and Simon Witney at Travers Smith

Q Where do you think the difficulties lie for the market in comprehending the scope of impact investing?

Simon Witney: The starting point is that private markets firms are very well positioned to generate impact, so the scope is significant. Investors into widely held public companies, especially when they are buying shares on the secondary market, have fewer levers to pull. There is a limit to what they can do to help a business develop in a certain direction, even if they can meet an impact definition.

The private markets model is, of course, different. Generally, impact investors are providing primary capital and, even when they are not, they will typically take board seats and have significant influence over strategy. That active ownership approach means firms can genuinely lay claim to transforming businesses.

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Jeremy Elmore: It is worth adding, however, that impact can be a difficult area to pin down. For example, the Global Impact Investing Network's (GIIN) definition of impact investments is helpful, but it can leave some areas open to interpretation and subjectivity. It says impact investments are "investments made with the intention to generate positive, measurable social and environmental impact alongside a financial return".

When you start to unpick that, the opening question has to be: what is the balance between impact and returns, and does a trade-off need to be made? It is certainly possible that the impact of a particular investment could be accelerated by foregoing an element of financial returns, but the question as to where the balance should properly lie will be specific to circumstances and

Q How is the regulatory environment helping or hindering clarity around impact investing?

SW: People are watching to see what comes out of the UK Financial Conduct Authority's deliberations on an 'impact' label. The FCA says the label is designed for retail investors but, given what happened with the EU's Sustainable Finance Disclosure Regulation (which wasn't a labelling regime but has often been treated as such), it could be that institutional LPs start to require or expect it to be used by private fund managers.

At the same time, the EU is considering revisions to the SFDR and it is seeking views on a similar labelling regime, but those discussions are at a much earlier stage and there is likely to be investor push back to radical change. In the meantime, some investors see SFDR's Article 9 as a proxy for an impact fund definition, but it was not designed for that and does not do the job very well.

One issue is that labelling investment products is not easy to do – how do you define impact in a way that is inclusive and allows for innovation, while also drawing clear boundaries that prevent greenwashing?

In my view, the most important priority outside of the retail market should be for the industry to move towards a common understanding of how to report on social and environmental impact. We need a consistent set of metrics, supported where necessary by qualitative, contextual information that allows investors to compare impact performance across managers. That should include negative impact. We are seeing European regulators focus on ensuring companies report on negative impact and, where possible, what they are doing to mitigate it. That's a positive development in my view, although not an easy one, and industry engagement is crucial to help regulators to get it right.

will depend on a subjective call by the GP.

Another factor in this is that, as GPs generally have engaged with ESG and sustainability, they have improved practices and put in place sophisticated strategies to deliver sustainable investments, some of which could be seen to have genuinely impactful outcomes. This can lead to the question as to where the dividing line lies between sustainable investing and impact investing. As GPs increasingly engage with sustainability in implementing their investment strategies, it is becoming harder to differentiate between the two and arguments can be put forward that what some are labelling impact strategies really don't go beyond sustainability-driven investment.

Then there is the big challenge of how you measure impact in an empirical way. In some respects, it has become easier to measure environmental aspects with the development of metrics on carbon emissions, for example, but social impact remains much more difficult to pin down.

Q How are you seeing funds approach some of these definitional challenges?

SW: Many impact investors will look for 'co-linearity', where the impact and the financial outcomes are positively correlated. This can help address the question Jeremy raised around balancing impact and returns, because there is no trade-off. An example would be an investment in a solar park: the more renewable energy is generated, the greater the positive environmental impact, and the greater the financial returns.

Of course, co-linearity is not always possible, but the risk with investing in a business where there is a trade-off between impact and returns is that the impact may be temporary and may not outlast the funds' ownership. An example of this would be where impact comes from a business giving something away or donating to a good cause for every product it sells, the 'buy one, give one' model. A new owner, looking to increase profits, might decide to change that model.

Naturally, there are other ways to seek to embed impact in the DNA of a business. One is to register the company as a B Corp, which involves changing the company's constitution, getting a certification from B Lab and reporting regularly on impact. While a new owner might decide to de-register from the B Corp regime, this would be a significant step with reputational consequences.

On the measurement point, there is an increasing recognition in the market – and it is inherent in the GIIN definition – that an impact investor needs to

have an intention to generate positive impact from the outset. An investor into a company that sets out to provide low-cost social housing, for example, needs to have a 'theory of change' that identifies exactly what it is trying to achieve from an impact perspective. It should commit to report against clear metrics that will indicate whether it has been successful, such as how many people have benefited, what their income ranges were, and so on. It is then possible for stakeholders to judge whether the targeted change has been achieved.

On the other hand, the question of 'additionality' in impact investing is more problematic. It requires firms to show that the impact would not have happened if they had not been involved. That is difficult because it involves proving a negative and, in many cases, if the project will deliver returns it is hard to show that someone else would not have funded it.

Q How are LPs and GPs coming together on some of these issues and where are the sticking points?

JE: LPs are taking different views on this. Some are developing impact investing programmes that rely on the LP's traditional role as an allocator of capital – by that I mean they are targeting investments into funds that adopt appropriate policies, but the LPs will then leave it to the manager to determine how to implement these policy goals.

Others are taking a more prescriptive approach, by imposing their own standards and requirements on GPs (including by requiring compliance with their own policies in these areas). This can sometimes lead to difficulties between GPs and LPs as it limits the discretion available to the GP as to how to drive impact within its strategy and at the portfolio company level.

One of the big advantages of private markets is that contractual terms are freely negotiable between GPs and LPs, but a source of frustration can be when an LP makes ESG requirements non-negotiable (by requiring conformity with its own impact targets and assessment metrics).

This can be problematic because a GP will need to balance the needs and requirements of a number of LPs and ensure that its investment process is proportionate and consistent with its human and technical resources. This is possibly less of an issue for larger, well-resourced managers that are likely to be driving the agenda, but it can be challenging for less established managers facing a take-it-or-leave-it offer.

We are seeing some moves to align GP and LP impact objectives using more innovative tools, such as carry linked to ESG or impact targets. This can be an effective solution, but it needs to be carefully thought through. The targets need to be sufficiently stretching to change behaviour and you need to avoid a cliff-edge, where a manager reaches the specified impact hurdle and has no incentive to go further. As with traditional carry structures focusing on financial returns, the incentive to maximise the impact outcome has to be entrenched.

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>
> **JEREMY ELMORE**

Q How do you see the impact space, and the market's understanding of it, evolving over the coming years?

JE: The market will evolve because of the scale of capital that is ready to invest in strategies with an environmental and/or social impact. This will encourage new entrants and, as this happens, we will see a wider pattern of behaviours and therefore a drive towards improvement as competitive forces kick in. We are likely to see the development of best-in-class practices and managers who are genuinely able to provide differentiation through the implementation of these practices.

SW: Some managers have been conservative about opting in to SFDR Article 9 and the 'principal adverse impact' regime because they were concerned – rightly in my view – about signing up to something that was not sufficiently clear or achievable. Now that we have more clarity, and firms have had time to adjust, I think we will start to see the market evolve, and regulation can play a positive role in this evolution. I think it will become standard for funds to account for their negative environmental and social impacts and to explain how they are seeking to mitigate those, and metrics will converge.

Beyond that, more capital will seek out positive impact opportunities and the private markets are very well placed to take advantage of that shift in investor preferences. Firms that can set out a credible theory of change and use their active ownership approach to put it into effect have the power to drive better outcomes and stronger accountability. ■

Jeremy Elmore is a partner and Simon Witney is a senior consultant at Travers Smith